# Get $mart About Credit

MONTANA STATE UNIVERSITY EXTENSION

## How Much Debt is Too Much?

Imagine working for five days and only getting paid for three. That is the equivalent of owing 40% of what you earn. Unfortunately, it is the typical consumer credit situation for American households who have debt exceeding 40% of their income. Easily available credit and slick advertising has made living beyond one's means very tempting.

How much debt is too much? The amount of credit you can handle comfortably depends on your income, your living expenses, and your current debt obligations. The size and lifecycle stage of people in the household will also influence your "*debt comfort level*."

**Consumer debt ratio**

To get a quick look at how you're doing, first evaluate your current status by calculating your Consumer Debt ratio. List all loans and credit card balances, find the total sum. MSU Extension has a worksheet to record the creditor name, remaining balance on your loans, payment amount, and the interest rate at: www.creditsmarts.montana.edu/pdf/powerpayworksheet.pdf

For a safe level of credit outstanding, financial planners recommend that individuals or families commit no more than 15%-20% (excluding home mortgages) of monthly take-home income to credit payments. If your ratio is higher, your alternatives are:

- Stop taking on new debts
- Eliminate some of the debts as quickly as possible

**Debt-ratio calculation**

List total outstanding loan balance $_______ = A
List your take-home income $____________ = B
Then divide A by B______________________ %

*Example:* Take home income $5,100 per month. The total balance on four credit cards is $16,000. ($5,100 ÷ 16,000 = .31 or 31%)

**One-third limit**

Another common guideline: Limit your credit payments to a third of what's left after you've paid your basic living expenses. The worksheet below will help you.

| How to calculate what you can afford in monthly credit payments | |
|---|---|
| A. Monthly take-home pay | $_______________ |
| B. Mortgage/rent | $_______________ |
| Transportation/vehicle | $_______________ |
| Utilities | $_______________ |
| Food | $_______________ |
| Clothing | $_______________ |
| Medical expenses | $_______________ |
| Savings | $_______________ |
| Other | $_______________ |
| C. Total basic living expenses (Add all items in B). | $_______________ |
| D. Subtract line C from line A: | $_______________ |
| E. Divide line D by 3. This is the dollar amount you can safely spend on monthly credit payments. | $_______________ |

*(Over)*

Example: Take-home pay $5,100 per month. Living expenses are $4,300. $5,100 - $4,300 = $800. This is the amount left to spend on monthly credit payments but a wise financial manager would set aside some of the amount for an emergency fund.

**Housing debt**

Keeping your payments for housing and vehicles in line is important. A dream home and luxury vehicle would be nice, but can you really afford to repay those debts? To decide how much to spend on a home, refer again to the worksheet on page 1. For this calculation, from your monthly take-home pay, subtract all of your basic living expenses except what you currently spend for housing. The dollar figure you get is what's available for your mortgage and the extra costs of maintaining a home.

Several rules of thumb can keep you from becoming "house poor."

- Your total monthly cost for housing (mortgage, taxes, utilities, maintenance, and insurance) should not exceed *one-quarter* to *one-third* of your monthly take-home pay.

> **For example:** If your take home income is $3,500 each month, your housing costs should be between $875 and $1,155
> ($3,500 x 0.25) = $875
> ($3,500 x 0.33) = $1,155

- The price of your home should not be more than 2 to 2½ times your before-tax annual income.

> **For example:** If your salary is $30,000 a year before taxes, the cost of your home should be between $60,000 and $75,000
> ($30,000 x 2) = $60,000
> ($30,000 x 2.5) = $75,000

Lenders use two other rules of thumb to estimate the maximum housing payment you can afford and to decide how much they will lend you. Be sure the amount you qualify for fits into your personal budget.

- **Front-end ratio.** The cost of your house payment, including real estate taxes and home owner's insurance, shouldn't exceed *25 to 31 percent* of your before-tax annual income.

> Using this method with an average of 28 percent, a couple that makes $54,000 could afford annual housing costs of about $15,120 ($54,000 x 0.28) per year ($1,003 per month).

- **Back-end ratio.** Your total monthly debt payments—mortgage, real estate taxes, insurance, auto loans, and all other debts—shouldn't exceed 33 to 41 percent of your before-tax monthly income.

> Using this method with an average of 37 percent, the same couple might qualify for any loan that doesn't push their monthly debt payments over $1,325 (monthly income of $3,583 x 0.37).

**Vehicle debt**

A general guideline when buying a vehicle is that you shouldn't spend more than 15 percent of your before-tax annual income for transportation. This includes your vehicle payment, insurance, gasoline, and maintenance. A down payment or trade-in can help you lower the cost of your loan.

**Summary**

Be aware of your income and expenses before committing future earnings to repaying debt. Remember that it's not enough to simply cover today's costs. To survive an illness or job loss, you also need an emergency fund. Experts suggest setting aside enough money to last two to three months.

**Fact sheet adapted from:**

"How Much Debt is Too Much?", University of Idaho Extension, Marsha Lockard, Bulletin 841, September 2004.